

BACKGROUND

INFORMATIONAL HEARING ON

TAX EXPENDITURES:

Benefits, Tradeoffs, and Economic Impacts

Wednesday, November 5, 2003

1:30 p.m. – 4:40 p.m.

State Capitol, Room 126

Sacramento, California

INTRODUCTION TO THE HEARING

Each year, state legislators introduce hundreds of bills that impact the Revenue and Taxation Code and that grant preferences designed to favor a particular activity, industry, or class of persons. Some of these bills incentivize taxpayer behavior; others offer more equitable tax treatment to certain taxpayers than they are afforded under existing law; still others are intended to stimulate one or more sectors of the economy, conform state tax law to federal tax law, or ease tax law administration. These provisions take many forms, such as exclusions from income, deductions, credits against tax, tax exemptions, tax deferral, or special rates. Despite their differences, virtually all of these provisions can be categorized as tax expenditures.

Over time, hundreds of tax expenditures have been added to California's tax code. At last count, these tax expenditures sum to over \$35 billion annually. Depending on one's perspective, California's tax expenditures represent foregone state revenue or tax relief. However, regardless of one's perspective, few would argue that the state's tax expenditures warrant periodic review. Their sheer number and monetary value justify such review. The need for review is even more heightened in today's tight fiscal times.

With this hearing, the Assembly Revenue and Taxation Committee and the Jobs, Economic Development, and the Economy Committee examine tax expenditures. We will begin by introducing the topic -- defining the term, reviewing how many exist, and learning about the history of tax expenditure reporting by state agencies. During the main phase of the hearing, presenters will discuss the ways in which various state agencies calculate the fiscal impacts of tax expenditures. Recent legislation [AB 990 (Ridley-Thomas)] proposes that the Assembly and Senate Budget Committees review the state's tax expenditures as part of the annual budget process. During the hearing, invited witnesses will discuss the pros and cons of this proposal. Witnesses will also offer advice regarding the policy protocols that should be followed and the economic factors that should be considered when proposing and evaluating tax expenditures. A representative from the Office of the Legislative Counsel will round out the tax expenditure discussion by reviewing the vote requirements necessary to enact, modify, suspend, and/or eliminate tax expenditures.

Testimony from the invited witnesses is expected to provoke considerable debate, because, although virtually no one questions the importance of evaluating existing and proposed new tax expenditures, there is significant disagreement about how these evaluations should be done and how and when the evaluations should be used.

The background information that follows in the remainder of this paper is intended to set the context for testimony that will be offered by the invited witnesses.

THE DEFINITION OF "TAX EXPENDITURE"

"Tax expenditures" were defined under the Congressional Budget and Impoundment Control Act of 1974 (the federal budget act) as "revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability." According to the federal Joint Committee on Taxation, federal tax expenditures include any reduction in income tax liability that results from special tax provisions or regulations that provide tax benefits to particular taxpayers.

California's Budget Act does not define the term tax expenditure. However, the California Department of Finance (DOF) has defined tax expenditures as provisions of tax law that result in the collection of fewer tax revenues than would be collected under the basic tax structure. The definition used by DOF is sufficiently broad to include several provisions of California's Revenue and Taxation Code, such as income and franchise tax credits and deductions, sales and use tax and property tax exemptions, and income and franchise tax exclusions. However, DOF's definition does exclude several broad categories of California's tax laws. For example,

- Because the basic structure of each tax is used as the starting point for determining what constitutes a tax expenditure, elements of the basic tax structure that exempt certain groups are not considered tax expenditures. For example, the sales tax is imposed on retailers for the privilege of selling *tangible personal property* at retail.

According to its basic definition, California's sales tax does not apply to sales or leases of real property or sales of services. Therefore, these exemptions are not considered tax expenditures; rather, they are elements of the basic tax structure.

- Across-the-board tax rate reductions do not represent tax expenditures. Rate changes would only represent tax expenditures if a particular set of rates were very narrowly targeted to specific taxpayers.
- Progressive or regressive rate structures do not constitute tax expenditures. For example, the basic structure of California's personal income tax is progressive. Applying different tax rates to different income groups is a basic characteristic of the tax and does not represent a tax expenditure.
- Exemptions or exclusions required by federal law or the federal Constitution are not tax expenditures.
- Changes in tax law that alter penalties or interest or that accelerate or defer tax payments are generally not considered tax expenditures unless they are very narrowly targeted to specific taxpayers.

The Legislative Analyst's Office (LAO) defines tax expenditures more broadly than DOF in recognition of the fact that individual legislators have differing views about which tax provisions should be included as part of the basic tax structure and which should be classified as tax expenditures.

Lack of a single definition for the term tax expenditure at the state level can yield different estimates regarding the total number of tax expenditures offered under current law. However, this difference is seldom significant from a policy perspective. Tax policy debates rarely focus on whether a particular provision of the tax code is a tax expenditure or an element of the basic tax structure. Far more commonly, debate focuses on the merit of specific tax law provisions.

LIST OF TAX EXPENDITURES

Both the LAO and DOF produce tax expenditure reports in which they list existing tax expenditures and their estimated revenue impacts. The DOF's report, required by law to be produced annually, is a relatively slim volume included in Appendix A. The LAO's tax expenditure report, also required by law, is published less frequently but is more comprehensive. The last comprehensive tax expenditure report produced by the LAO is dated February 1999. Its length prevents its inclusion in an Appendix to this background paper. However, an updated listing of existing tax expenditures and their estimated revenue impacts that was prepared by the LAO at the request of the Chair of the Committee on Revenue and Taxation is included in Appendix B.

CLASSIFICATION

Tax expenditures come in many different sizes and shapes and can be classified in many different ways (e.g., according to type of tax, revenue impact, length of enactment, purpose, etc.). Persons undertaking tax expenditure evaluations often find it helpful to classify tax expenditures according their purpose, because evaluations commonly focus on whether a particular tax expenditure is meeting its original purpose. The following is an example of a classification scheme that uses purpose as the basis for the classification:

- Equity: Equity measures remove perceived inequities in existing tax law. For example, AB 426 (Cardoza), Chapter 156, Statutes of 2001, exempted liquefied petroleum gas pumped into external storage tanks for residential use from sales and use tax. The exemption was an equity measure, because it placed rural homeowners who use propane for heat on equal sales tax footing with urban homeowners whose gas and electricity was already exempt from sales tax.
- Incentive: Targeted tax reductions are intended to incentivize certain taxpayer behavior. These tax expenditures may involve any combination of exemptions, credits, deductions, or exclusions.
- Stimulative: A category of tax reductions that can overlap with incentive measures, stimulative tax reductions are intended to increase the amount of profitable economic activity conducted within a particular geographic region, within the entire state, or within a particular economic sector (such as high-technology or manufacturing). Like incentive measures, stimulative measures can involve any combination of exemptions, credits, deductions, or exclusions.
- Relief: Measures that provide either broad-based or targeted tax relief are generally intended to help a certain sector of the economy. Relief measures sometimes overlap with equity measures and typically include rate reductions or exemptions.
- Conformity: These measures conform state tax law to federal tax law. They are intended to reduce tax law complexity, reduce taxpayer compliance costs, and ease tax law administration.
- Administrative: Administrative measures are intended to reduce administrative costs by easing tax law administration.

TAX EXPENDITURES VERSUS BUDGET EXPENDITURES

The term "tax expenditure" is somewhat of a misnomer. Rather than representing an expenditure of money, a tax expenditure works in reverse – it stops the collection of a certain amount of revenue. Revenue that is not collected cannot be expended.

There are significant differences between tax expenditures and budget expenditures, particularly in California. Some of the more significant are as follows:

- Budget expenditures require a 2/3rds vote for enactment and generally require a 2/3rds vote for repeal.¹ Tax expenditures require a simple majority vote for enactment and a 2/3rds vote for repeal.
- Budget expenditures are typically reviewed once per year as part of the annual budget process. Once enacted, tax expenditures are seldom (if ever) reviewed.
- The size of a budget expenditure is usually capped at a certain level and requires a 2/3rds vote of the legislative to be increased. The amount of revenue that is foregone through the adoption of a tax expenditure is usually uncapped.

Although tax expenditures and budget expenditures are fundamentally different from each other, there are a few commonalities. Tax expenditures are most similar to those direct spending programs that have no spending limits and that are available as entitlements to those who meet the statutory criteria established for the programs.

MEASURING THE FISCAL IMPACT OF TAX EXPENDITURES

Theory

Economists generally recognize three different types of economic impacts when they estimate the quantitative effect of any particular tax law change on state and local government revenues. The three types of impacts that are generally recognized include static, direct effect, and dynamic. Revenue estimates that quantify these impacts are called static revenue estimates, direct effect revenue estimates, and dynamic revenue estimates, respectively. A brief explanation of each type of impact and the assumptions that would be used to estimate the revenue impact of each impact follow:

- A static impact is the most short-term in nature and represents the immediate economic effect of any given change in the tax law. A static revenue estimate prepared for a sales tax exemption would equal the sales tax rate multiplied by the dollar value of total sales of the exempted item. Similarly, a static revenue estimate prepared for an increase in the cigarette tax rate would equal the incremental increase in the tax rate per pack of cigarettes multiplied by total packs of cigarettes sold.
- A direct effect revenue estimate takes direct economic effects into account by incorporating the initial ripple effects of a tax law change on the economy. Because they reflect secondary behavioral responses, direct effect estimates are longer-term in nature than static revenue estimates. Following the examples above, a direct effect estimate prepared for a sales tax exemption would reflect changes in consumer purchasing habits resulting from the exemption. The estimate would equal the sales

¹ One exception to this general rule is the Governor's line-item veto authority, which requires only a stroke of the Governor's blue pencil rather than a vote of the Legislature.

tax rate multiplied by the dollar value of total sales expected to result after the exemption is enacted. Similarly, a direct effect estimate prepared for an increase in the cigarette tax rate would take a decline in cigarette consumption into account. The estimate might also consider the possibility that some taxpayers will switch from cigarettes to other forms of taxable tobacco that will generate different amounts of revenue.

- A dynamic revenue estimate takes all of the ripple effects of a tax law change into account. It represents the long-term impact of the tax law change on the economy and estimates how the economy will be changed once it returns to equilibrium approximately five to eight years after a tax law change is enacted. Following the examples above, a dynamic revenue estimate prepared for a sales tax exemption would examine the question of how many new jobs and how much new investment was created by the exemption. A dynamic revenue estimate prepared for an increase in the cigarette tax rate would examine the increase in productivity and decrease in health care costs likely to result from a decline in cigarette consumption. It would also account for the number of jobs likely to be lost due to a decline in cigarette sales.

Practice

When a law affecting the Revenue and Taxation Code is introduced, the applicable tax agency estimates the fiscal impact of the proposal. The Board of Equalization (BOE) estimates the fiscal impact of changes affecting the tax laws it administers (Sales and Use Tax Law, Property Tax Law, and a myriad of special taxes and fees including the cigarette and other tobacco products tax, fuel taxes, alcoholic beverage taxes, and others). The Franchise Tax Board (FTB) estimates the fiscal impact of changes affecting the Personal Income Tax and Corporation Tax Laws. Both of these agencies generally prepare static estimates. However, when reliable information is available that allows the preparation of a direct effect estimate, the agencies will use it. In all cases, the tax agencies document the assumptions they use when developing their estimates.

The ability of both tax agencies to develop their revenue estimates is directly related to the amount and type of information required to be reported by taxpayers on the returns they submit to these agencies. Typically, very little information regarding the value of sales tax or property tax exemptions is reported on tax returns filed with BOE. The returns contain taxable sales and taxable property rather a breakdown of all sales into taxable and nontaxable amounts or a breakdown of all property into taxable and nontaxable amounts.

More information is available to FTB on income tax returns, but even these returns are limited in the information they contain. Credits are the easiest income tax expenditures to track, because they must frequently be claimed on special forms and reported on special lines; deductions are harder to track because less information is required to be reported by taxpayers; exemptions and exclusions can be the hardest to track, because – as is the case with sales tax and property tax returns – a taxpayer generally reports taxable income, not nontaxable income, to FTB.

There is a trade-off involved in requiring more information to be reported on California's tax forms. On one hand, increasing the amount of information required to be reported has the potential to improve the tax agencies' abilities to estimate the revenue impacts of proposed tax law changes. Additional information might also be helpful to those seeking to evaluate the effectiveness or efficiency of existing tax law provisions. However, requiring taxpayers to report more information increases both taxpayer compliance costs and tax agencies' administrative costs to revise instruction booklets, key in the reported information, and evaluate it.

In 1994, SB 1837 (Campbell), Chapter 383, Statutes of 1994, was enacted in order to improve the state's ability to predict the responsiveness of tax revenues to changes in the tax code. That measure required both the LAO and DOF to perform dynamic revenue analyses of proposals that were estimated to have a fiscal impact of \$10 million or more using static revenue estimating techniques. The LAO was required to perform its analyses on proposed changes to the annual budget that involved changes in state tax law; DOF was required to perform its analyses on all other proposed changes to state tax law. In order to comply with SB 1837's legislative directive, DOF built a computable general equilibrium model of California's economy.

The DOF's model predicts the long-term impact of proposed changes in state tax law. The model approximates the California economy by relying on hundreds of equations that predict the response of producers and consumers within an integrated economy. First-order responses produce second- and third-order responses, which ripple through the modeled economy until a new equilibrium is reached. The model generates three types of economic impacts: revenue feedback (discussed below), changes in private non-residential investment (reported in millions of dollars), and changes in employment (reported in number of jobs).

Feedback effects represent the amount by which the stimulative effects of a tax expenditure ripple through the economy to offset some of the revenue loss predicted using static revenue estimating techniques. For example, when DOF uses its model to simulate a large, broad-based, state corporation tax reduction, the model returns an 18% to 20% feedback effect. In round numbers, this means that a proposed tax law change that is estimated to reduce Corporation tax revenues by \$100 million will reduce tax revenues by between \$80 million and \$82 million when the stimulative effects of the tax reduction are considered; the remaining \$18 million to \$20 million will be recovered through the stimulative effects of the rate reduction. The DOF model predicts that a broad-based sales and use tax rate reduction will generate a feedback effect of between eight and ten percent (i.e., a sales and use tax rate reduction estimated using static techniques to reduce revenue by \$100 million will cost the state between \$90 million and \$92 million; the remaining \$8 million to \$10 million will be recovered through the stimulative effects of the rate reduction). Finally, DOF's model predicts a 3% feedback rate for broad-based personal income tax rate cuts. The feedback effects of targeted rate cuts differs somewhat from feedback effects calculated for broad-based cuts but are usually of a similar order of magnitude.

AGGREGATE VALUE OF TAX EXPENDITURES

People are often tempted to add each of the individual revenue impacts listed in either the DOF or the LAO documents and conclude that the sum represents the aggregate amount of revenue foregone by the state. However, a sum generated in this way would be misleading. Because of interactions between different tax expenditures and prohibitions against so-called double-dipping (i.e., claiming more than one tax benefit for undertaking a single action), the cumulative amount of revenue foregone by the state is likely to be somewhat less than the sum of each individual provision.

However, summing the cost of individual tax expenditures does yield an order-of-magnitude approximation of the magnitude of revenue foregone by the state. Using both the DOF and LAO reports, the aggregate value of state tax expenditures is in the range of tens of billions of dollars annually.

THE IMPACT OF TAX EXPENDITURES ON LOCAL GOVERNMENTS

When performing revenue estimates, state agencies often focus on the impact of a tax expenditure on the state. However, many tax expenditures also have significant local impacts. Revenue impacts are the most common type of impact, particularly when the state enacts a sales and use tax exemption. Because the sales and use tax is both a state and local source of tax revenue, a state decision to enact a sales and use tax exemption often results in a loss of local government revenue. Revenue and Taxation Code Section 2230 requires the state to reimburse local agencies for their net loss of revenues resulting from sales tax exemptions enacted by the state, but this section is typically not enforced. Legislation authorizing sales and use tax exemptions commonly includes language stating that, "Notwithstanding Section 2230 of the Revenue and Taxation Code, no appropriation is made by this act and the state shall not reimburse any local agency for any sales and use tax revenues lost by it under this act."

State-enacted property tax exemptions can also have local revenue impacts. Revenue and Taxation Code Section 2229 requires the state to reimburse local agencies for their net loss of revenues resulting from property tax exemptions enacted by the state, but – in a similar manner to the Section 2230 requirement discussed above – this section is typically not enforced. Legislation authorizing property tax exemptions commonly includes language stating that, "Notwithstanding Section 2229 of the Revenue and Taxation Code, no appropriation is made by this act and the state shall not reimburse any local agency for any property tax revenues lost by it pursuant to this act." This generally means that cities, counties, special districts, and redevelopment agencies lose property tax revenue when the state enacts a property tax exemption. The state's school funding obligations require state backfill of any loss of property tax revenue by school districts.

Other examples of local impacts resulting from state-enacted tax expenditures include those relating to local economic development, changes in local land use patterns, and changes in the amount of open space.

EVALUATING TAX EXPENDITURES

The sheer number of tax expenditures that are currently part of California's Revenue and Taxation Code and the approximate aggregate value of revenue foregone by the state due to these expenditures provides ample justification for a close evaluation of these expenditures. An evaluation is also supported by the age of some of the state's existing expenditures. Because of the 2/3rds vote needed to repeal an existing tax expenditure, few tax expenditures have been repealed.²

The number and magnitude of existing tax expenditures, together with the difficulty of repealing them, also strongly suggest the need for close study of proposed *new* tax expenditures. Particularly in a year where the state expects a large budget shortfall, any proposal to reduce the amount of revenue available to the state warrants close inspection.

Yet, while few if any would disagree about the merits of evaluating existing and proposed new tax expenditures, there is considerable debate over what criteria should be used to make such an evaluation. When framing the debate, it is useful to define nomenclature. Three common types of evaluation include the following:³

- Utilization: Utilization reflects the extent to which an expenditure is used by those to whom it is made available. In the case of a tax expenditure, information regarding utilization would involve how many taxpayers claim the credit, deduction, exemption, or exclusion; the aggregate value of all claims; and a distributional analysis of the claims (e.g., the annual incomes of individual claimants, the annual gross receipts of business claimants, the industry sector to which business claimants belong; the geographical distribution of claimants; etc.).

Because of their access to taxpayer data, tax agencies are in the best position to report to the Legislature regarding utilization of a given tax expenditure. But, as noted in an earlier section, while a great deal of information is reported on tax returns, a great deal of information is also missing. Revising tax forms to collect additional information that would allow more comprehensive reporting has a cost that legislators must consider when deciding whether to require the additional information to be reported.

- Effectiveness: The term effectiveness means different things to different people. To a business, the effectiveness of a tax expenditure may be measured by the number of new jobs it creates or the amount of new investment it generates. To a labor group, effectiveness may relate to the quality of the jobs that are created (e.g., their wage and benefit levels). To an environmental group, effectiveness may relate to whether open space land is preserved or anti-sprawl land use decisions are incentivized. Public

² As noted in DOF's Tax Expenditure Report in Appendix A, most of those that have been repealed have done so automatically because of the existence of sunset dates. Legislative action has seldom been taken to repeal a tax expenditure without a sunset date.

³ These terms apply equally as well to budget expenditures as to tax expenditures.

interest groups may grade a tax expenditure on whether it redistributes income from wealthier to poorer Californians or improves the quality of public services.

The task of measuring effectiveness begins with determining what the word "effective" means. Yet, it does not end there. Once one decides what is meant by "effectiveness", one must attempt to measure it. Tools for measuring effectiveness include information regarding utilization and available studies regarding specific outcomes believed to be correlated in some way with a given expenditure. However, in an economy as large as California's and among a population as diverse as California's, it is important to distinguish between correlation and causation. An increase in the number of jobs in a particular industry or a particular geographic area that occurs shortly after a tax expenditure is enacted represents a correlation; the job increase does not prove that tax expenditure caused the jobs to be created.

Often, even correlations will not be apparent. California's trillion dollar economy makes it extremely difficult to discern the specific impact of tax law changes, even when they are very large. The impacts of smaller tax expenditures can be nearly impossible to discern.

These measurement challenges are compounded by the dimension of time. Sometimes a tax expenditure may take several years for its impact to be seen. For that reason, an effectiveness study undertaken too early may reach a conclusion far different from a study undertaken after the impact of the expenditure is felt.

The challenges noted above do not suggest that effectiveness evaluations should not be performed. Rather, a discussion of the challenges is intended to point out how difficult and often time-consuming and labor-intensive effectiveness evaluations can be to perform properly. Requiring that effectiveness evaluations be performed for every existing and proposed new tax expenditure has a cost that legislators must consider when deciding the merits of requiring these studies to be done.

- Efficiency: Efficiency involves gaining the greatest value per dollar of expenditure. A simple example illustrates the difference between effectiveness and efficiency. A tax expenditure that creates 100 new jobs may be effective. However, if the state foregoes \$200,000 in revenue per each new job created, the tax expenditure may not be as efficient as another use of the same funds. This example also illustrates that efficiency is determined by comparing different alternatives to each other; it cannot be determined in a vacuum.

It is precisely because an efficiency evaluation requires the analysis of more than one alternative that efficiency evaluations are the most time consuming and labor-intensive evaluations of the three discussed in this paper. As was noted regarding utilization and effectiveness evaluations, the depth and intensity of the effort required to perform a credible efficiency evaluation suggests a significant cost. Before requiring an efficiency evaluation, the legislature must determine an appropriate trade

off between the cost to perform the study and the importance of the information that will be gained.

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